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Short-run political events and stock market reactions: Evidence from companies connected to Malaysian bi-power business-political elite

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Abstract

Based on the Efficient Market Hypothesis, this paper investigates market reactions to short-run political events in the companies connected to bi-power business–political elite of the state of Sarawak in Malaysia. We find that the under-reaction market behaviour of investors existed in politically connected firms upon the announcement of extraordinary political events. By contrast, evidence of overreaction behaviour was detected upon the holding of the Balingan general election. This study suggests that in short run political events, investors are unable to predict abnormal returns in politically connected companies upon the announcement of surprising political news. This signals an inefficient market.

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Keywords: stock market reaction; political connection; short-run political event

1. Introduction

The value of political connections is well documented in economics and finance literature (Johnson & Mitton, 2003; Faccio, 2006; Gomez, 2009; Mitchell & Joseph, 2010; Yusoff, Salleh, Ahmad, & Idris, 2015). However, such value is inadequately explained. Numerous studies highlight the close opportunist relationship between politicians and business elites (Gomez, 2009; Bliss & Gul, 2012; Fraser et al., 2006). By becoming business tycoons, prior studies

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suggest that politicians can obtain state favours without any intermediaries (Bunkanwanicha & Wiwattanakantang, 2009). Examples of national leaders of countries who are also business tycoons include Thaksin Shinawatra (Thailand), Tung Chee Hwa (Hong Kong), Ferenc Gyurcsany (Hungary), Silvio Berlusconi (Italy), and Paul Martin (Canada). Despite the pervasiveness of bi-power business–political elites, little is known about the influence of their power on the market, especially when dealing with short-run political events. Our empirical study fills this gap in the literature and provides strong evidence of an important fundamental link between finance and politics by examining market behaviour in response to short-run political events.

Given the fact that the close link between business and politics in Malaysia has long been recognised in finance and economics literature (Johnson & Mitton, 2003; Fraser et al., 2006; Gomez, 2009), a recent event in Malaysia provides an ideal setting for investigating this phenomenon. Within the businesses in East Malaysia, the influence of a politically exposed person namely the Sarawak Chief Minister, Abdul Taib Mahmud and his family remains questionable (Jomo, 2004; Faeh, 2011; Woon, 2012). Taib is particularly known as the most powerful and wealthiest timber tycoon in Sarawak (Bruno Manser Fund (BMF), 2012). Although the name of Taib is rarely listed as a director or a shareholder, his family members are known to act as nominees for the chief minister. Taib was also the longest serving Chief Minister in Sarawak (33 years in power) and has held various ministerial positions in the Federal Government since the 1970s.

Based on the business and political powers of Taib, any good or bad news about him is expected to immediately affect stock market reaction. Bilson et al. (2002) argued that political risks may be able to explain several variations in emerging market returns. Moreover, following the classical study of Fama (1970) on efficient-market hypothesis (EMH), share prices at any time "fully reflect" all of the available information of the firm. Thus, any bad or good news that affects the bottom line of a firm will be immediately capitalised into its share price without bias. In this regard, the announcement of Taib regarding his resignation and retirement as the Chief Minister of Sarawak on February 28, 2014 may reflect a surprising shock to the stock market.

For the purpose of this study, we use a short-run event to analyse the relationship between Taib's announcement of his resignation and retirement and the stock market reaction by studying a sample of firms politically connected to Taib. Our findings provide investors with useful insights into the reaction of stock price volatility in politically connected firms to unexpected political events in Malaysia.

The remainder of this paper is organised as follows: The next section presents a review of the literature and the hypotheses. The following sections provide an elaboration of the methodology and a discussion of the results respectively. The final section concludes the paper.

2. Taib Mahmud: Timber tycoon in Malaysia

Sarawak is located on the island of Borneo in East Malaysia, and it is the largest of the 13 states of Malaysia. It is multiracial and rich in lush tropical rainforest. Sarawak is relatively distinct from Peninsular Malaysia because none of the 27 ethnic groups of the former forms a majority. However, Sarawak has been dominated by a single party [Barisan Nasional (BN) coalition] since the first district council elections in 1963 (Woon, 2012). The primary form of political patronage in Sarawak is the distribution of timber extraction contracts. These contracts were widely expanded when Taib Mahmud became the Chief Minister of Sarawak in 1981 (Faeh, 2011). He was the fourth Chief Minister and the president of Parti Pusaka Bumiputra Bersatu (PBB), which is part of the BN coalition.

As the chief minister, state finance minister, and planning and resources minister, he awarded himself, his family and the elite PBB members with vast timber concessions, palm oil concessions, state contracts, and directorships in various prominent companies in Sarawak (Bruno Manser Fund, 2012). The findings of a study conducted by the Bruno Manser Fund in 2011 on the businesses connected to Taib in Malaysia and overseas, revealed that Taib and his family are connected to more than 400 companies in 25 countries and offshore districts involving among others, timber logging, log exporting, construction, plantation and power supply.

With regards to politics, the rise of East Malaysia BN parties in the 2013 general election likewise strengthened the political position of Taib where the majority seats of Sarawak BN in the Parliament increased the Federal Government's dependency on Taib (Chin, 2014). However, a year after the general election, speculation on the retirement of Taib intensified once again, and the media descended on the PBB headquarters (The Sun Daily, 2014, The Borneo Insider, 2014; The Star, 2014). Eventually, after 33 years of service, Taib finally announced his retirement as the Chief Minister of Sarawak on February 28, 2014. By considering the bi-power of Taib in business and politics,

the announcement of his resignation and retirement may potentially influence stock market reaction, especially among companies that were closely related to him and his family members.

Several studies have proven that the stock market is directly influenced by political risks and uncertainties (Bilson et al., 2002; Beaulieu et al., 2006; Gift & Gift, 2011). The findings of these studies imply that event-announcement may create abnormal returns to shareholders, which may induce stock over-reaction or under-reaction behaviour. Norli Ali et al. (2010) explain that the Malaysian stock market overreacts to economic crises and extraordinary political events, such as the announcement of the removal of the deputy prime minister and announcement of the resignation of the prime minister suggesting that surprising political news may affect the over-reaction behaviour of investors. Meanwhile, the authors likewise stated that investors under react to the announcement of general elections because it has been well announced and well deliberated in mass media. Wu and Wang (2005) found that asymmetric information between informed managers and the public market may also potentially induce the under-reaction behaviour of investors. Similarly, Kirchler (2009), who studied the effects of asymmetry in mispricing between bullish and bearish markets, confirms that evidence exists of price under-reaction to news that has an asymmetric information problem. By closely examining the pattern of unanticipated events, Choi and Hui (2014) suggested that investors under-react to surprising headline news and over-react to extremely surprising news. Meanwhile, Maher and Parikh (2011) proved that investors under-react to negative events in all periods except post-crisis where the market appears to over-react to bad news.

Despite the abundant studies on political and market reactions, our knowledge on the effect of bi-power business–political elites on market behaviour remains scarce. Therefore, by applying a short-run event study methodology and a sample of the politically connected firms of Taib Mahmud (one of the bi-power business-political elites), this study analyses the effects of Taib's resignation and retirement news on the short-run market reaction in his related companies.

3. Sample Selection and Methodology

The sample of this study consists of daily stock return data of the publicly listed companies connected to Taib in Malaysia from October 2, 2013 to March 5, 2014. The list of his related companies was obtained from the Bruno Manser Fund (2012) reports. The selected samples are in line with the wealth assessment of Taib and his family, which is based on the value of their stakes in the listed companies. The time period for this study corresponds to the event of interest, which is the resignation and retirement of Taib as the Chief Minister of Sarawak. Companies from the financial services industry were excluded from the sample because these companies are subjected to regulations different from those in other industries. The sectoral stock market index database was obtained from the Thomson DataStream. This procedure resulted in 17 companies with 2448 total year observations.

Following the seminal paper of MacKinlay (1997), we perform the initial task in conducting an event study that is, defining an event of interest and identifying the event period. As shown in Figure 1, three event windows should be defined, namely, estimation, actual event, and post-event windows. The estimation window is determined based on a pre-event period for each stock. This process involved the setting of parameters for normal return model. MacKinlay (1997) suggests that 120 days prior to the event study is suitable for daily data analysis. The actual and post-event windows are determined to capture the abnormal returns of the stocks. The three windows should not overlap to prevent the event from influencing the normal performance model.

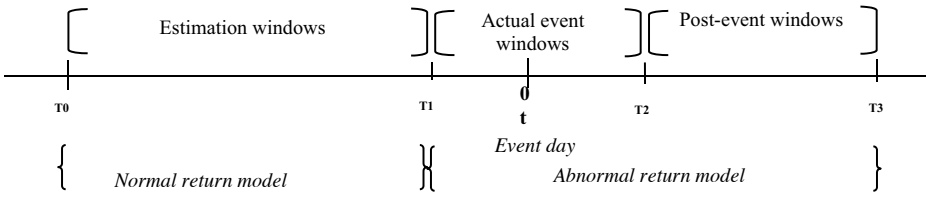

Figure 1: Timeline for an Event Study

Table 1 shows that the actual and pre-event windows were identified based on four main events of interest during the resignation and retirement of Taib.

Table 1. Events of interest during the resignation and retirement of Taib Mahmud

Event no.	Event Interest	Event day	Actual event (3 trading days)	Post-event (4 trading days)
1st event	Rumours of Taib Mahmud retirement	5/2/2013	04/2/2014 –06/2/2014	07/2/2014 – 12/2/2014
2nd event	Resignation and retirement of Taib Mahmud as chief minister of Sarawak and vacating of Balingan seat	28/2/2014	27/2/2014 –01/3/2014	02/3/2014 – 07/3/2014
3rd event	Nomination to Balingan seat	17/3/2014	14/3/2014 – 18/3/2014	19/3/2014 – 24/3/2014
4th event	BN won the elections in Balingan	29/3/2014	28/3/2014– 30/4/2014	01/4/2014 – 05/4/2014

The four events of interest were selected because of the possibility of abnormal returns occurring after the announcement of the aforementioned news.

3.1. Estimating normal return model

Stock return is defined as the percentage of change in the daily stock price, inclusive of any dividends (Gift & Gift, 2011). However, the normal return is the effect of general market movement on stock prices. By contrast, abnormal return is the effect of companies, industries, or specific occurrences on the price of a stock. To obtain abnormal returns, we initially estimated the normal market model for a 123-day estimation period for each stock, from October 2, 2013 to February 3, 2014. The model is as follows:

$$\text{Estimation windows:} \qquad R_{it} = \alpha + \beta_i R_{mt} + \epsilon_{it}, \qquad t = -123, \ldots\ldots, -2, \tag{1}$$

Where:

R_{it} is the return for firm *i* and day *t*, R_{mt} is the return on an equal-weighted industrial market portfolio on day *t*, and α and β_i are regression parameters.

Checking the unit root test is important prior to estimating the normal market model. This procedure is used to determine the nature of non-stationarity that most time series and panel data exhibit. This methodology is based on Dickey and Fuller (1979), which became popular over the past years. Table 2 presents the results of the unit root test in the current study.

Table 2. Results from the panel unit root test

Variables	At levels
	ADF test
R (individual stock return)	-2.731***
RM (market return)	-3.005***

Based on the results, all of the variables are stationary at "at levels." For this reason, we employed simple ordinary least squares (OLS) in estimating the slope coefficient of the normal return model.

3.2. Sensitivity Analysis of the Abnormal Return

To perform the sensitivity analysis, this study calculates the abnormal returns for firm *i* as follows:

$$AR_{it} = R_{it} - [\hat{\alpha} + \hat{\beta}_i R_{mt}], \quad t = -123, \ldots\ldots, 5 \tag{2}$$

The coefficients $\hat{\alpha}_i$ and $\hat{\beta}i$ are OLS estimates from the regression of the daily returns of firm *i* on the normal market model over 123 days prior to the actual event window. The complete price response to new information can

potentially take several days; thus, cumulative abnormal returns (CARs) are calculated over multiple trading days as per actual and post-event windows. We construct CAR as follows:

Actual event windows: $CAR_{it} = AR_{i-1} + AR_{i0} + AR_{i1}$ (3)

Post event windows: $CAR_{it} = AR_{i2} + AR_{i3} + AR_{i4} + AR_{i5}$. (4)

In this study, the actual event window extends from one day before to one day after the actual event day. The post-event window is defined as two to five days after the actual event day. In event studies, starting the window one day before the actual announcement day is common in case the news has leaked to the market just before the actual press release. We keep the event window relatively short for two reasons. First, we are interested in the immediate effects of news on stock prices. Second, we intend to minimise the chance that another press release is issued by the firm within the same window. If a press release was made after trading hours, then the announcement day is assumed to be on the next trading day.

To test the sensitivity of the market reaction, we calculate the average CAR (ACAR) for each news category across all event observations. We propose three hypotheses as follows:

H1: ACAR = 0, for all stocks in actual event windows –all stocks in post-event windows
H2: ACAR= 0, for all loser stock portfolios – all winner stock portfolios in all related industries
H3: ACAR = 0, for all loser stock portfolios–all winner stock portfolios in all events of interest

The mean difference in ACAR for all event windows/stock portfolios was estimated and tested using the t-test. In this study, we assume that the announcement of the resignation and retirement of Taib may provide bad news to companies related to him. Thus, the negative and significant t-values imply that actual event windows/loser stock portfolios have underperformed post-event windows/winner stock portfolios during the test period.

4. Results and discussion

4.1. Descriptive statistics

The descriptive statistics of ACARs for all four events of interest are shown in Table 3. Based on the results, none of the means is significantly different from zero. During the actual event day, the mean average returns of all company stocks are negative at 37.3%, 34.9%, and 82.1%. Moreover, all of the mean average returns after the event day are positive at 0.2698, 1.1668, 0.228, and 0.063.

Table 3. Descriptive analysis of mean average accumulated abnormal returns (ACARs)

Variable	Mean actual event	Mean post event
1st event	-0.373	0.2698
2nd event	-0.349	1.1668
3rd event	-0.821	0.228
4th event	-0.350	0.063

Figure 2(a) presents the separate ACAR histograms based on all events day within each company. Based on the histograms, distributions are reasonably symmetric around zero. The results appear to support normal reaction within all companies related to Taib. Next, in Figure 2(b), we plot a separate ACAR histogram for all companies during each event day. Surprisingly, the majority of the events are on the negative return side. This result raises the following question: Could the announcement of the resignation and retirement of Taib provide bad news to the companies related to him? A stark difference exists in the distribution of ACARs around the event period. This visual evidence has an interesting implication, which requires further sensitivity analysis.

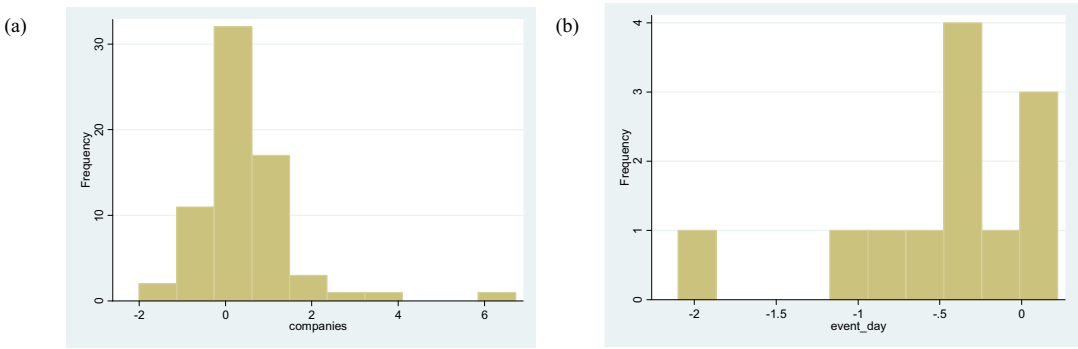

Figure 2 (a) Frequency histogram of daily average cumulative abnormal returns (ACARs) by type of stock;
(b) Frequency histogram of daily average cumulative abnormal returns (ACARs) by date.
(ACARs are on the x-axis)

4.2. Results of the Short-Run Event Study

Table 4 presents the results of the short-run event study employed in this study. The findings support Hypothesis1 in that investors underreact to the bad news of the resignation and retirement of Taib, except for the 4th event (BN won the elections in Balingan). The differences in mean average returns for the1st, 2nd, and 3rd events are -0.643, -1.516, and -1.050, respectively, and are statistically significant at the 5% level with significant negative effects. These results are consistent with stock under-reaction behaviour, which suggests that the news incorporates slowly to the prices. The average return of a company's stocks is lower following the announcement of bad news and higher following the announcement of good news (Spyrou et al., 2007; Maher & Parikh, 2011; Stefanescu et al., 2012).

The results contradict with those of Norli Ali et al. (2010), which claim that surprising political news in Malaysia, such as the announcement of the removal and resignation of Malaysian political elites, influence the overreaction behaviour of investors. Interestingly, in the case of politically connected firms, investors under-react to the announcement of resignation and retirement of bi-power business–political elites such as Taib. This result is consistent with those of Wu and Wang (2005) and Kirchler (2009), which state that in the case of private benefits control, asymmetric information between informed managers and the public market induces the under-reaction behaviour of investors. Moreover, the news may not be highly surprising to the closely connected firms of Taib and the stock sizes of these firms are in the medium- and small-capitalisation indices compared to the total market capitalisation of all publicly traded companies in Bursa Malaysia (Choi & Hui, 2014; Maher & Parikh, 2011).

The results of the current study also present no evidence of stock under-reaction behaviour existing in the politically connected firms in the period of the Balingan general election. The results contradict those of Norli Ali et al. (2010). One possible reason for these contradict results is that the nominated candidate of BN in Balingan was neither the one suggested by Taib nor a member of his family. Thus, this news is highly surprising to companies closely related to Taib.

Table 4. Differences of ACAR for stocks in actual event–post-event date

Variable	Mean actual event–post-event	t-stat
1st event	-0.643	-2.27**
2nd event	-1.516	-3.13**
3rd event	-1.050	-1.60**
4th event	-0.414	-0.624

To test the second hypothesis, we examined the winner–loser effect using the family stock portfolios of Taib in all of the industries involved. As shown in Table 5, the winner has significantly outperformed the loser at the 1% significance level in industrial products and plantation industries, whereas construction industries failed to exhibit any significant results. Thus, Hypothesis 2 is supported for industrial products and plantation industries, which is consistent

with stock under-reaction behaviour. These results are consistent with Kirchler (2009), who stated that in treatments with asymmetric information, bullish markets exhibit a significantly lower degree of under-reaction behaviour.

Table 5. Differences of ACAR loser–winner in the test period for all industries involved

Variable	Mean Loser	Mean Winner	Mean Loser-Winner	t-stat
Construction	-0.2624399	0.3340403	-0.5964802	-1.6264
Industrial product	-0.4052745	1.039884	-1.445158	-4.3320***
Plantation	-0.2742411	1.232781	-1.507022	-14.1408***

To provide further evidence, we conducted an additional sensitivity test for loser–winner stock portfolios in all events of interest. The results also presented negative and significant effects at the 1% to 5% significant levels for all events of interest (see Table 6). Thus, the winner portfolio in all events has been undervalued and the loser portfolio was overvalued. These results suggest that asymmetric information between informed managers and the public market exists in politically connected firms. (Kirchler, 2009) explains that in markets with asymmetric information problems, information trickles down over time from the insiders to traders with the worst fundamental information. Thus, the information dissemination process evolves significantly slower until traders with information receive the "new" fundamental value. Finally, underreaction of price changes to variations in fundamental value induces overvaluation in bearish markets and undervaluation in bullish markets.

Table 6. Differences of ACAR loser–winner in the test period for all events involved

Variable	Mean Loser	Mean Winner	Mean Loser-Winner	t-stat
1st event	-0.2705	0.65617	-0.92665	-5.9919***
2nd event	-0.5965	0.96278	-1.55929	-2.6468**
3rd event	-0.7388	0.46733	-1.20608	-2.0134**
4th event	-0.6496	0.60043	-1.25002	-3.1051**

5. Concluding remarks

In this study, we introduce short-run political events based on companies that are closely related to bi-power business–political elites to extend empirical evidence on stock market behavior. The results indicate that after 33 years of service, the resignation and retirement announcement of Taib as chief minister of Sarawak on February 28, 2014 provides negative value to companies that are closely related to his family. By using various objective measures of market reaction and political event windows, we determine that investors underreact to all events of interest that are related to the resignation and retirement announcement of Taib, especially his connected firms in industrial product and plantation industries.

The result generates numerous new predictions. First, in the case of politically connected firm, investors underreact to the surprising bad news regarding the political announcement. This result suggests that asymmetric information exists between informed managers and the public market. Second, the announcement of bad political news is not extremely surprising to politically connected firms. One possible reason is that the unexpected news has been well announced and well deliberated in the top management of the companies. Third, winner stock markets significantly outperform loser stock markets in all event studies, which implies that underreaction behavior exists between insiders and traders. Finally, winner stock market is undervalued and loser stock market is overvalued. Moreover, evidence of overreaction behavior to the Balingan general election is significantly anticipated by this study. The reason is that Barisan Nasional rejected the nominated candidate that Taib suggested; which was highly surprising to companies that are closely related to him. Therefore, the news influences the family stock market portfolio of Taib.

Overall, this study contributes to the economic and finance literature in several aspects. First, evidence of short-term behavior presented in this study proposes that stock markets in politically connected firms are consistent with the weak form of EMH in the short run. Second, investors are unable to predict abnormal returns in politically connected firms upon the announcement of surprising political news. Third, if asymmetric information exists in politically connected firms, then predicting future prices based on past information to earn excess profit is difficult. Finally, well-announced events, such as general elections, do not underreact to the stock market at all times. Therefore, this study

suggests that asymmetric information problems in politically connected firms weaken stock market efficiency in the short run. Nevertheless, this study also has its limitations. By using daily data in the short-run event study, the announcement of abnormal day returns may be biased based on statistical error in estimating normal returns model (Ahern, 2009). Thus, estimating the effects of market reaction on a long-run political event is open for further research.

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